

A Framework For Thinking About Enterprise Formalization

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Formalization is a historical process

- The transition from informal to formality has underpinned industrialization in all rich countries: it is a natural part of development.
 - The process is slow but is triggered gradually by changes in the business enabling environment and the demands of market expansion.
 - It depends on the voluntary recognition by both firms and governments that costs of formalization are legitimate and worth bearing.
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Why formalization is an issue in developing countries

- Informality limits enterprise growth: at some point in their development entrepreneurs need to interact with formal structures. Either they comply or are locked out.
 - Informality undermines governments: states support private sector development by providing public goods and selective interventions. Tax evasion deprives them of resources to do so.
 - Informality carries large environmental and social costs. In the long run these can undermine whole economic sectors (e.g. fisheries)
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The benefits of formalization for entrepreneurs

- Participating in large scale markets requires entrepreneurs to interact with formal systems:
 - Access to banking services and credit requires formal accounting and some degree of managerial transparency
 - Integration into global value and supply chains requires compliance with product standards and CSR – to minimize reputational risk

 - Formalization can also give entrepreneurs a sense of security and legitimacy
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The benefits of formalization for governments

- ❑ Generate a level playing field for formal firms & break down 'informality traps' – apply rules fairly and safeguard competition
 - ❑ Gather information about economic activity; create a framework for revenue collection and public goods provision etc. (c.f. Professor Ayee's presentation).
 - ❑ Inform the process and content of policy dialogue to improve the business environment for all firms.
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Why is formalization not happening?

- ❑ Entrepreneurs are afraid to expose themselves: regulatory compliance creates new collection points and opportunities for rent-seeking.
 - ❑ They do not want to put themselves at a competitive disadvantage: why formalize when nobody else does? Calculation leads to informality.
 - ❑ A paradox: massive migration from the formal to the informal sector ('informalization') where traditional investment climate reforms implemented.
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Solutions – limit scope for abuses & build trust

- Limit opportunities for rent-seeking:
 - Create real time monitoring systems to trace and punish abuses.
 - Provide incentives to enforce regulations fairly: improve salaries and benefits.

 - Build reciprocity and trust:
 - Explain government resource allocation: where does the money go?
 - Strengthen content and process of policy dialogue with informal firms
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Also improve information flows and provide practical support

- Improve information flows:
 - Decentralize policy-making to sector and cluster level; highlight near term opportunities.

 - Provide practical support:
 - Develop linkage and capacity building programs to help informal firms integrate into supply chains.
 - Develop investment promotion packages to generate opportunities for economic transformation
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Thank You!

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